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IN THE

Supreme Court of the United States

October Term, 1937.

[redacted] 65
No. ......

DOUGLAS FAIRBANKS,
Petitioner,

against

UNITED STATES OF AMERICA,
Respondent.

PETITION AND BRIEF FOR WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

ARTHUR F. DRISCOLL,
Counsel for Petitioner.

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INDEX.

CASES CITED.

STATUTES AND DOCUMENTS.

RULINGS OF COMMISSIONER.

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PETITION FOR A WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Douglas Fairbanks, respectfully prays for a writ of certiorari to the Circuit Court of Appeals for the Ninth Circuit, to review a judgment of that Court entered on April 2, 1938 (R. 139).

Opinions Below.

The opinion of the District Court is not officially reported, but is printed in full at Record pages 51 to 55. The opinion of the Circuit Court of Appeals is not as yet officially reported, but appears in full at Record pages 132 to 138.

Jurisdiction.

The date of judgment is April 2, 1938. Jurisdiction is invoked under Section 240-A of the Judicial Code, 28 U. S. C. A., Section 347.

Cases Believed to Sustain the Jurisdiction.

Burnet v. *Harmel,* 287 U. S. 103;
United States v. *Kirby Lumber Co.,* 284 U. S. 1.

Statutes Involved.

Section 208(a)(1) of the Revenue Revenue Act of 1926 (44 Stat. 19) and Section 101(c)(1) of the Revenue Act of 1928 (45 Stat. 811) are printed in full in Appendix "A."

Questions Presented.

This case presents an important question of the law of Federal income taxation which has never been passed upon by this Court and, as is shown hereinafter, is a continuing source of litigation between taxpayers and the Bureau of Internal Revenue. The specific questions at issue are:

(1) Does the redemption before maturity of bonds by the issuing corporation constitute a *sale or exchange* for the purpose of income taxation as to the owner and holder of the bonds, within the meaning of Section 208(a)(1) of the Revenue Act of 1926 and Section 101(c)(1) of the Revenue Act of 1928.

(2) Does the gain realized by the bondholder from the redemption constitute

(a) capital gain from the sale or exchange of a capital asset, taxable at the 12½% rate: or

(b) ordinary income, taxable at both normal and surtax rates.

Summary Statement of the Matter Involved.

There is no issue of fact. All the facts are admitted by the pleadings, or have been stated as special findings of fact by the District Court.

The material facts are as follows:

Fairbanks is a citizen of the United States and a resident of California.

He has been engaged in the business of making motion pictures since the year 1916 (R. 59).

In the year 1925 Fairbanks was the owner of eight completed motion pictures and one in the process of making (R. 60).

Under date of March 5, 1925, Fairbanks made a contract with The Elton Corporation, under the terms of which he transferred to The Elton Corporation all his right, title and interest in the nine motion pictures aforementioned in exchange for $4,000,000 par value debenture bonds, and 990 shares of no par value stock of said corporation, said bonds being ten-year bonds, dated March 5, 1925, and maturing March 5, 1935 (R. 60).

The debenture bonds received by Fairbanks contained the following provision:

> "This debenture bond may be redeemed by the corporation at any time at its face value plus interest earned and unpaid hereon upon thirty days notice to registered holder hereof" (R. 60).

Fairbanks entered into a contract with The Elton Corporation at the same time, containing a provision that the corporation obligated itself to redeem $100,000 face value of the bonds per year beginning three years after date of the contract; that is, after March 5, 1925 (R. 60).

The Elton Corporation did redeem and Fairbanks did surrender for redemption $1,600,000 par value of said debenture bonds in 1927 (R. 60); $150,000 par value in 1928 (R. 61) and $150,000 par value in 1929 (R. 61).

Fairbanks duly filed his income tax returns for the years 1927 and 1928 and reported therein the sums received from the redemption of said debenture bonds (R. 62, 63). He took no deduction for cost, but reported the gross sum received as taxable (R. 62, 63). The amount received from the redemption of said bonds he reported as taxable at the capital gain rate of 12½%.

At the same time—that is, during the years 1927, 1928 and 1929—Fairbanks still had before the Commissioner of Internal Revenue a dispute as to taxes for the years 1917 to 1926, involving the question of whether or not the cost of motion pictures could properly be deducted in the year in which expended (R. 61, 64), as had theretofore been customary.

In December, 1929, a settlement was reached with the Commissioner of Internal Revenue as to said years. The settlement involved a recomputation of the taxes for those years on the basis of capitalizing the cost of pictures and amortizing said cost over a period of four years after the release of each picture—that is, 75% of the cost to be amortized in the first year, 15% in the second year, 5% in the third year, and 5% in the fourth year. Fairbanks, pursuant to said settlement, paid additional taxes and interest for the years 1917 to 1926 in the sum of $695,840.53 (R. 64). Pursuant to the settlement and recomputation, it was determined that Fairbanks still had an unamortized cost of pictures of $1,096,445.52 as of December 31, 1926 (R. 64) which he was entitled to deduct from his income for the following years in accordance with the aforesaid formula.

However, pending the settlement and before the unamortized cost had been fixed, Fairbanks had duly filed his Federal income tax return for the year 1929 and reported the amount received from the redemption of bonds of The Elton Corporation at the capital gain rate of 12½%. In that return he used as cost to be recouped, or the unamortized cost, the sum of $928,630.87 and deducted a proportionate part of $928,630.87, or the sum of $34,823.65 (R. 65-66).

Under date of August 7, 1930, one L. E. Fellers, an Internal Revenue Agent, made his report of his audit of the Federal income tax returns filed by Fairbanks for the years 1927, 1928 and 1929, treating the proceeds in question as capital net gain, taxable at 12½%, and fixing the unamortized basic cost as of December 31, 1926, at $1,096,445.52 (R. 66).

Following the report of Revenue Agent Fellers, Fairbanks filed with the Commissioner of Internal Revenue claims for refunds for the years 1927, 1928 and 1929, setting forth therein that he had not deducted from his income a proper cost for the bonds redeemed (R. 67-68).

Thereafter the Commissioner of Internal Revenue caused an audit to be made in connection with the claims for refund filed for the years 1927, 1928 and 1929 (R. 71). The Commissioner of Internal Revenue determined that Fairbanks was entitled to refunds for the years in question, and on January 26, 1932, did refund to Fairbanks for the year 1927 the sum of $53,231.55, together with interest in the sum of $9,795.05; for the year 1928, $7,507.38, together with interest in the sum of $932.40; for the year 1929, $677.57, together with interest in the sum of $42.99 (R. 72-73).

Thereafter the Commissioner of Internal Revenue determined that the refunds were erroneous and, through the Collector of Internal Revenue at Los Angeles, on July 6, 1933, officially demanded the return to the Government of the sums refunded (R. 73, 74).

No part of the sums refunded has been returned (R. 74).

Specification of Errors.

The errors which petitioner will urge if the writ of certiorari is granted are that the Circuit Court of Appeals for the Ninth Circuit erred:

1. In ruling that the redemption of its bonds by The Elton Corporation during 1927, 1928 and 1929 was not a "sale or exchange" of capital assets by Fairbanks within the meaning of the Revenue Acts of 1926 and 1928.

2. In ruling that Fairbanks must pay income tax on the gain from said redemption at normal and surtax rates instead of at the 12½% tax rate on capital gains as provided in the Revenue Acts of 1926 and 1928.

3. In ruling that the refunds made to Fairbanks on January 26, 1932, by the Commissioner of Internal Revenue were erroneous and that the United States was entitled to recover the amounts of said refunds with 6% interest thereon from the date of their payment.

4. In not ruling that Fairbanks had overpaid his Federal income taxes for the years 1927, 1928 and 1929.

Reasons for Granting the Writ.

Petitioner submits that the following reasons exist why this Court should grant a writ of certiorari:

1. *The Court below has decided an important question of Federal law which has not been, but should be, settled by this Court and in a way probably in conflict with applicable decisions of this Court on similar problems arising under the same provisions of the Revenue Act.*

It is conceded that The Elton Corporation bonds had been held by Fairbanks for over two years prior to their redemption and that they constituted "capital assets" as defined in the Revenue Acts of 1926 and 1928.

The sole question is, therefore, whether redemption of bonds before maturity constitutes a "sale or exchange" within the meaning of the Revenue Acts. This question has never been ruled upon by this Court and petitioner respectfully submits that such a ruling should be had for the reasons hereinafter set forth.

In 1921 Congress first legislated into the Revenue Act the remedial sections of these Acts known as the "Capital Gain and Loss" provisions, giving taxpayers the right to have such gains taxed at a flat rate of 12½% instead of at the extremely high normal and surtax rates.

The purpose of said legislation is found in Report No. 350 of the Ways and Means Committee of the 67th Congress, First Session, to accompany H. R. 8246, which is reprinted herein as Appendix "B."

This Court has given a similar clear statement of the reasons and problems causing the passage of the "Capital Gain and Loss provisions," in *Burnet* v. *Harmel,* 287 U. S. 103, where it is stated:

> "Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, re-enacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on *gains resulting from a conversion of capital investments,* and to remove the deterrent effect of those burdens on such conversions. House Report No. 350, Ways and Means Committee, 67th Cong., 1st Sess., on the Revenue Bill of 1921, p. 10; see *Alexander* v. *King,* (C. C. A. 10th), 74 A. L. R. 174, 46 Fed. (2d) 235." (Emphasis supplied.)

From the viewpoint of the bondholder, Fairbanks, the redemption of the bonds was the parting with capital assets—bonds—in exchange for money paid to him. It was a transfer of title for money. In 1925 he exchanged a capital asset—moving pictures—in return for a capital asset—bonds. In 1927, 1928 and 1929 he exchanged a capital asset—bonds—for money. Surely, Fairbanks has complied with the requirements stated by Mr. Justice Stone in *Burnet* v. *Harmel, supra,* in that he realized "gains resulting from a conversion of capital assets."

Fairbanks respectfully submits that the narrow construction placed upon the words "sale or exchange" by the Circuit Court of Appeals for the Ninth Circuit denies him the benefit of remedial legislation passed for the very purpose of protecting persons in his position and is in contravention of the expressed intent of Congress in so passing such legislation.

2. *The granting of a writ of certiorari will eliminate much litigation.*

Certainty in the principles and law of taxation is beneficial to both taxpayers and the Bureau of Internal Revenue. The present problem cries for an authoritative and final ruling, as the many changes in position on the present problem of both the Bureau of Internal Revenue and the Courts have been costly both to the Bureau and taxpayers and the source of much litigation between them.

A short historical resumé of this problem from an income tax standpoint reveals the following vacillating and contradictory constructions of the words "sale or exchange" by the Bureau of Internal Revenue and the Courts.

In 1923 the Commissioner ruled that the redemption of a bond at maturity could not be considered a "sale or exchange" of a capital asset, and the remedial 12½% tax rate did not apply (see I. T. 1637, II-1 C. B. 36, Appendix "C").

In 1929 the Board of Tax Appeals in *Henry P. Werner*, 15 B. T. A. 482 (acquiesced in by Commissioner), unanimously ruled otherwise.

The Commissioner thereupon revoked I. T. 1637 and promulgated I. T. 2488, VIII-2 C. B. 127 (Appendix "D"), and followed the *Werner* decision.

On July 27, 1930, the Board reaffirmed the *Werner* decision in *Alpin W. Cameron*, 20 B. T. A. 305, aff'd 56 Fed. (2d) 1021 (C. C. A. 3rd).

On December 29, 1932, the Board unanimously reversed *Henry P. Werner, supra*, in *John H. Watson, Jr.*, 27 B. T. A. 463 (acquiesced in by Commissioner), by holding that the redemption of a bond at or prior to maturity did not constitute a "sale or exchange." The Commissioner followed by revoking I. T. 2488, *supra*, and promulgated I. T. 2678, XII-1 C. B., 117 (see Appendix "E").

The next move in the checkered career of this problem was evolved by taxpayers more fortunate than Fairbanks whose bonds matured after the *Watson* decision. To obtain the benefits of the capital gains provisions denied them by

the *Watson* case, these taxpayers sold their bonds at the redemption or call price to friendly purchasers the day before the day stated in the call for redemption. Over the Commissioner's opposition the Board of Tax Appeals ruled that these transactions constituted a true "sale or exchange" and taxpayers so doing were not affected by the *Watson* decision, but could use the remedial 12½% flat tax rate.

John D. McKee, Trustee, et al., 35 B. T. A. 239.

These shifting and conflicting decisions have resulted in a flood of litigation between taxpayers and the Bureau. A few of the cases and situations involved are as follows:

(a) *Bonds redeemed at or before maturity.*

Ernest W. Brown, 36 B. T. A. 178;
Wm. C. Rands, 34 B. T. A. 1107 (on appeal, C. C. A. 6th);
Felin v. Kyle, 22 Fed. Supp. 556.

(b) *Promissory notes settled after maturity.*

Hale v. Helvering, 85 Fed. (2d) 819.

(c) *Life insurance annuities surrendered.*

George A. Hellman, 33 B. T. A. 901.

The natural result of the uncertainty created by these conflicting decisions was the petitioning of Congress by taxpayers to ameliorate the confusing situation by clarifying the law (see Recommendations of Committee on Taxation of American Bar Association, reprinted in Appendix "F").

Congress took cognizance of the situation and in Section 117(f) of the Revenue Act of 1934 provided that the redemption of a bond at or prior to maturity constituted the exchange of a capital asset, thus specifically removing from further controversy the problem involved in the instant case.

Petitioner respectfully urges that Section 117(f) of the Revenue Act of 1934 was not new law as concerns the

redemption of bonds, but was more explicit explanation of the purpose of prior laws.

> *Helvering* v. *New York Trust Co.*, 292 U. S. 455;
> *Jordon* v. *Roche*, 288 U. S. 446-455;
> *Merle-Smith* v. *Commissioner of Internal Revenue*, 42 Fed. (2d) 837-842;
> *McCauley* v. *Commissioner of Internal Revenue*, 44 Fed. (2d) 919-920.

Taxation being based on principles of equity, it seems inconceivable that Congress intended to benefit only taxpayers having bonds redeemed or maturing after January 1, 1934, to the exclusion of their less fortunate brethren whose bonds were called or matured prior to that date.

From the viewpoint of the Bureau and the Courts, parties to an identical transaction are treated in three different ways:

(a) Taxpayers like Fairbanks, who, relying on the *Werner* decision, were trapped by the *Watson* decision, are taxable on their gains at ordinary and surtax rates.

(b) Taxpayers having bonds maturing or redeemed after the *McKee* decision, *supra*, and taking advantage thereof, are taxable at the 12½% rate.

(c) Taxpayers with bonds maturing or redeemed after January 1, 1934, are taxable on their capital gains as provided in that Act.

Petitioner respectfully submits that this unfair and inequitable situation deserves an authoritative ruling from this Honorable Court.

WHEREFORE, it is respectfully submitted that this petition should be granted.

ARTHUR F. DRISCOLL,
Counsel for Petitioner.

APPENDIX A.

Statutes Involved.

Section 208(a)(1) of the Revenue Act of 1926 (44 Stat. 19) and Section 101(c)(1) of the Revenue Act of 1928 (45 Stat. 811) are identical, providing:

> "'Capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921."

APPENDIX B.

Report No. 350, 67th Congress, First Session, to accompany H. R. 8245 (Revenue Act of 1921):

> "CAPITAL GAINS AND LOSSES.
>
> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subject to an income tax in excess of 15 per cent., the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit taking transactions, but because the limitation of 15 per cent. is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

APPENDIX C.

I. T. 1637, appearing at II-1 C. B. 36, provides:

> "Revenue Act of 1921.
>
> Non-interest-bearing obligations of a political subdivision of a State were issued at 88 and upon maturity in the latter part of 1923 a taxable profit of 6 x will be realized by the holder not the original purchaser. Inasmuch as the obligations have been held for over two years inquiry is made whether the taxpayer will be subject to a tax on the capital net gain derived therefrom at the rate of 12½ per cent."

Section 206 of the Revenue Act of 1921 reads, in part, as follows:

> "(a) That for the purpose of this title:
>
> (1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.
>
> When an obligation matures it is neither sold nor exchanged. Any taxable profit derived upon maturity of a non-interest-bearing obligation is, therefore, not 'capital gain' derived from the sale or exchange of capital assets and section 206 does not apply."

APPENDIX D.

I. T. 2488, reported in VIII-2 C. B. 127, provides as follows:

> "Revenue Acts of 1921, 1924, 1926 and 1928.
>
> The net gain from bonds held for more than two years, whether received as the result of the maturity of the bonds or as the result of their redemption before maturity, may, at the option of a taxpayer other than a corporation, be taxed as a capital net gain under the provisions of section 206 of the Revenue Act of 1921. I. T. 1637 (C. B. II-1, 36) revoked.

Likewise, any individual who has held stock in a corporation for more than two years and who derives a gain when the stock is 'called in' may elect to have such gain taxed as a capital net gain in the manner and subject to the conditions prescribed in section 206 of the Revenue Act of 1921.

The foregoing ruling is also applicable under the Revenue Acts of 1924, 1926 and 1928.

A ruling is requested as to the manner in which the gain from bonds or stock held for more than two years should be treated where the bonds are redeemed before their maturity date or the stock is 'called in.'

Under the provisions of section 206 of the Revenue Act of 1921, any taxpayer (other than a corporation) who for any taxable year derives a capital net gain may elect to be taxed on such capital net gain at the rate of 12½ per cent. in lieu of the tax he would otherwise pay on such income under sections 210 and 211. Section 206 of the Revenue Act of 1921 reads, in part, as follows:

> (a) That for the purpose of this title:
>
> (1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

In I. T. 1637 it was held that when an obligation matures it is neither sold nor exchanged. It was further held that any taxable profit derived upon maturity of an obligation is therefore not 'capital gain' derived from the sale or exchange of capital assets and section 206 does not apply.

Under date of February 19, 1929, the United States Board of Tax Appeals decided, in the case of Henry P. Werner (15 B. T. A. 482, see on page 56), that the redemption of bonds at a 'called' date for an amount in excess of the cost of the bonds to the bondholder results in a gain from the sale or exchange of capital assets within the meaning of section 206 of the Revenue Act of 1921. In the decision the legislative history of section 206 of the Revenue Act of 1921 was reviewed. It was stated that the Ways and Means Committee of the House and the Finance Committee of the Senate declared that the provision was intended

to be applicable to the 'sale or other disposition of capital assets.'

The ruling contained in I. T. 1637 is hereby revoked. The net gain from bonds held for more than two years, whether received as the result of the maturity of the bonds or as the result of their redemption before maturity, may, at the option of a taxpayer other than a corporation, be taxed under the provisions of section 206 of the Revenue Act of 1921.

Likewise, any individual who has held stock in a corporation for more than two years and who derived a gain when the stock is 'called in' may elect to have such gain taxed as a capital net gain in the manner and subject to the conditions prescribed in section 206 of the Revenue Act of 1921.

As the provisions of the Revenue Acts of 1924, 1926 and 1928 relating to capital net gains are similar to the provisions of section 206(a)(1) of the Revenue Act of 1921, the foregoing ruling is also applicable under those Acts."

APPENDIX E.

I. T. 2678, appearing in XII-1 C. B. 117, is as follows:

"Revenue Acts of 1921, 1924, 1926 and 1928.

I. T. 2488 (C. B. VIII-2, 127), which holds that the gain derived from stock of a corporation 'called in,' or the gain derived from bonds as the result of their maturity or redemption before maturity, where such stock or bonds have been held for more than two years, may be taxed as a capital net gain, is revoked, in so far as inconsistent with the decision of the Board of Tax Appeals in *John H. Watson, Jr. v. Commissioner* (27 B. T. A. 463, page 13, this Bulletin)."

APPENDIX F.

Recommendations of Committee on Federal Taxation of American Bar Association, submitted to Ways and Means Committee of 73rd Congress, Second Session, in connection with the hearings on the Revenue Act of 1934:

> "Section 101 (c) of the 1932 act defines capital gains and losses as the gains or losses resulting from the 'sale or exchange' of capital assets. The United States Board of Tax Appeals has determined in *Henry P. Werner,* 15 B. T. A. 482, that included within the terms of 'sale or exchange' was the redemption by the obligor, at or before maturity, of a capital asset. Later the Board held, in *Watson,* 27 B. T. A. 463, that such redemption was not a 'sale or exchange.' Your committee believes that the Congress did not intend to remove from the benefits of the capital gains and loss provisions gains or losses from the redemption of capital assets, especially when such gains or losses, if the assets had been sold by the holder immediately before redemption, would be considered capital gains or losses.
>
> Your committee recommends, therefore, the following resolution and amendment to Section 101 (c) of the 1932 act:
>
> 'Be it resolved, that the American Bar Association recommends to the Congress that the Congress redefine the terms "capital gain" and "capital loss" to make clear whether such terms include gains and losses resulting from the redemption at maturity of capital assets, and that the Association's Committee on Federal Taxation is directed to urge the following proposed amendment and, failing the acceptance of the proposal as drafted, its equivalent in purpose, upon the proper committee of the Congress:'
>
> (Proposed amendment.)
>
> 'That Section 101 (c) (1) and (2) be amended to read as follows: "(C) Definitions.—For the purposes of this title—" (1) "Capital gain" means taxable gain from the *sale, exchange or redemption* of capital assets consummated after December 31, 1921.

'(2) "Capital loss" means taxable loss resulting from the *sale, exchange, or redemption* of capital assets.' "

The above appears in the printed record of the reports of the hearings of the Ways and Means Committee on the Revenue Act of 1934, and will also be found in the reports of the American Bar Association, Volume 58, page 455, 1933.